

Policy Paper

Dependence of Belarusian economy on trading with Western European countries and USA

September 2005

Summary:

This policy paper was completed in September 2005 by an independent economic think tank from Belarus, which due to the sensitive political situation of the country does not wish to be named. The views presented in the paper are not necessary those of the Pontis Foundation.. The conclusion contains the remarks of the Pontis regarding the findings of the paper.

The analysis clearly demonstrates that the Belarusian economy is currently very dependent on the trade relationship with the EU. Significant restrictions on Belarus-EU trading (or an embargo on commodities exports from Belarus as the most radical option) may appear to impact the country extremely negatively. Such an impact would entail structural changes within the Belarusian economy and numerous negative trends. The most significant ones would include:

- GDP loss
- Employment and revenue reductions (both for enterprises and the population), and/or concealed unemployment growth
- Instability and imbalance within the internal currency market, BLR ruble devaluation, loss of a NBB currency resource share, and inflation growth
- Budgetary income and expenditure reductions and budgetary deficit growth

Alongside Russia which was previously the main economic partner for Belarus, the EU currently plays a significant role in Belarusian external economic policy.

Introduction:

In the past few years, Belarus has experienced significant transformations in its foreign trade sector. While the end of the 1990s through the beginning of this decade was characterized by a dependence on exports to the Russian Federation, during the last few years exports to non-CIS countries (EU mainly) have been rapidly developing. Such structural shifts in the foreign trade sector have substantially changed Belarus' medium- and long-term economic development prospects. Therefore, this study attempts to identify new leverages over the Belarusian economy and to evaluate the degree of its dependence on relationships with non-CIS countries, especially the US and EU.

Since 2001, steady trends of increasing Belarusian exports to non-CIS countries have been observed. By 2005 the share of exports to non-CIS countries considerably exceeded those of CIS members (table1). In the last few years export reorientation (from Russia to other markets) has been predominantly dependent on CIS countries (Ukraine in particular) rather than non-CIS ones. Nevertheless, within the 2001 – January-June, 2005 period export growth to non-CIS countries exceeded the CIS export rate.

The percentage of Belarusian cumulative exports to EU countries continues to increase (table 2). Although trade relations between Belarus and the US are not well developed, they have remained relatively stable. During the last three years, US exports and imports have comprised just over 1% of the overall export-import share in Belarus.

Until 2003, a negative balance of foreign trade with EU countries can be observed (import exceeded export more than twice). Since 2002, exports practically balanced imports, and in 2003 exceeded the latter by \$1.054 Mio. In 2004 Belarus – EU commodity trade balance reached \$1.804 Mio.

In 2004 Belarus – EU commodity turnover growth stood at 36%, with exports at 41.1%, and by January-June of 2005 the latter rate fell to 31.1%. Compared to imports, export growth appeared to be more dynamic. In 2004 export growth to the EU countries could be partially explained by the EU enlargement. Nevertheless, export growth was also ensured by market expansion within the EU territory.

Table 1. Geographical export structure

	2001	2002	2003	2004	1 half. 2004	1 half. 2005
CIS countries	60.3	54.7	54.6	53.1	52.9	43.9
Non-CIS countries	39.7	45.3	45.4	46.9	47.1	56.1
Total	100.0	100.0	100.0	100.0	100.0	100.0

Source: Ministry of Statistics and Analysis.

Table 2. Foreign trade with the US and the EU countries

	2003		2004		1 half. 2004		1 half. 2005	
	\$Mio	% total	\$Mio	% total	\$Mio	% total	\$Mio	% total
EXPORT								
EU	3567	35.95	4043	37.0	2233	36.23	257	44.1
USA	102	1.0	163	1.2	70.3	1.1	105	1.4
IMPORT								
EU	2513	21.73	239	20.0	1383	20.01	1484	21.0
USA	150	1.3	195	1.19	70.5	1.0	97	1.4
BALANCE								
EU	1054	--	1804	--	850	--	1773	--
USA	-48	--	-32	--	-0	--	8	--

Source: Ministry of Statistics and Analysis.

The main export items of Belarus to the EU are:

- Mineral products
- Chemical industry output
- Ferrous metals
- Textile and textile goods
- Wood and wood products

For Belarus, the most important trade partners among EU members are Germany, Great Britain, the Netherlands, and Italy.

According to the National Bank official data, in 2004 81.8% of all mineral products, 26.9% of ferrous metals, 23.7% of textile and textile goods, 18.6% of chemical and 9% of plastic outputs were exported to EU markets.

Mineral products comprised the largest share of overall exports to non-CIS countries in the last five years. (Fig.1) In 2004 mineral production export to non-CIS countries

comprised \$ 3,367 Mio, and in January – June, 2005 - \$ 2,356 Mio (\$ 1466 Mio as for January – May, 2004). Thus, mineral production exports was growing constantly, which was 80-100% ensured by seller's market expansion in non-CIS countries. Mineral products largely contributed to the overall export growth.

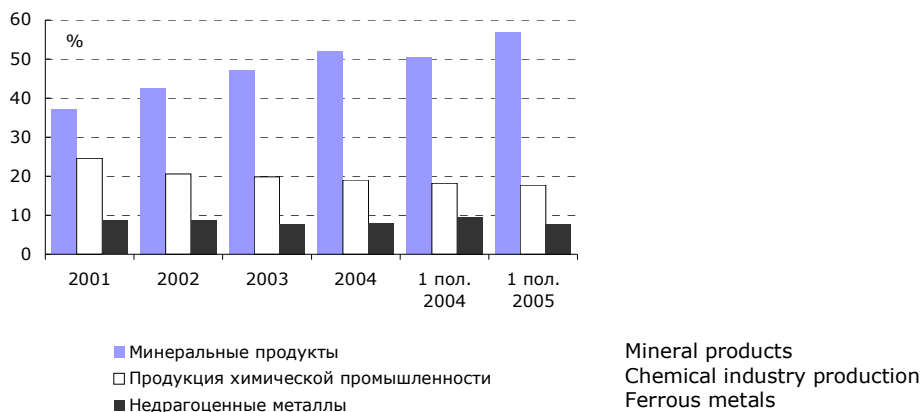
Mineral production export appeared to be considerably dependent on the separate markets of the EU countries. In the last years the largest share of oil products used to be exported to Great Britain, the Netherlands and Latvia. In January-June, 2005 oil and oil products delivered to the Netherlands comprised 40% of the export of all mineral products.

During the last five years the **chemical output** share stood second among exports to non-CIS countries. The largest share of chemical production is currently delivered to EU markets. Ferrous metals comprised 1/3 of overall export to non-CIS countries. Also, Belarusian textile and textile products are highly valued by European customers.

In order to estimate Belarusian economic dependence on the US and EU countries lets assume an embargo is introduced on commodity exports to these countries. Imagine that this hypothetical situation gives no possibility for Belarus to export its goods intended for Western Europe and the US through Russia or other CIS countries. Thus, such an analysis would help to adequately evaluate the economic relationship between the EU and Belarus.

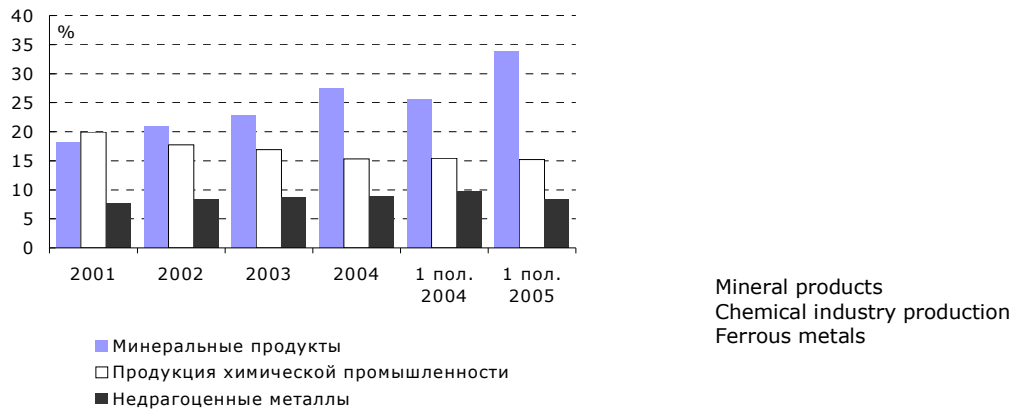
The following analyzes the consequences of such an embargo introduction on Belarus and the immediate transformations which would inevitably follow. For a more detailed description of the shock influence mechanisms we divide this period into three stages. We will analyze the economic consequences for Belarusian real, monetary-credit, and budgetary sectors within every stage.

Fig.1. Share of main export items to non-CIS countries



Source: Ministry of Statistics and Analysis

Fig. 2. Share of main export items to non-CIS countries within cumulative export



Source: Ministry of Statistics and Analysis

Economic consequences of embargo introduction:

Stage 1: Output decreases, currency income losses, and budget income decreases

Real sector

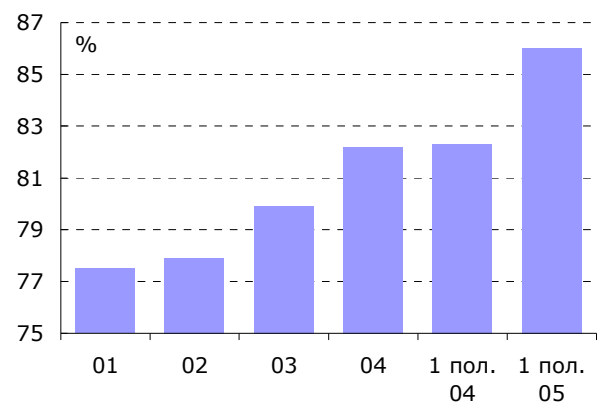
The embargo introduction would bring the most drastic consequences on the oil industry (oil refinery). 80% of oil products, produced in Belarus, are exported to the EU (\$ 2, 086 Mio as of the first half of 2005). Moreover, overall Belarusian oil export (\$ 165 Mio as for the first half of 2005) is also delivered to EU countries. Oil industry ensures more than 20% of industrial output. Thus, due only to the oil industry GDP loss may reach 5 %.

Smaller branches of industry (light, chemical, oil-chemical, and woodworking) would likely be less sensitive to an embargo. However, the consequences for these branches will be quite serious. As the domestic market potential is totally exhausted, these industries would be forced to compete with their Russian counterparts, and any reorientation toward other non-CIS countries may require a certain period of time. Ferrous metallurgy and potash fertilities output would also likely be less affected by an embargo (in the 1st half of 2005 about 40% of ferrous metals and 19% of potash fertilities were exported to the EU countries).

Monetary sector

Introduction of an embargo on Belarus' export to the EU countries would mean an abrupt currency loss for Belarusian exporters. The country's enterprises currently receive about 60% of overall export income from EU countries. An embargo would badly influence exporting of commodities which share in cumulative export income, which comprise a bit more than 50%. The impossibility of exporting to the EU would also considerably reduce income from service delivery to EU countries. For Belarus, a positive balance in service trade **is more than 100% ensured by** transport services exports, which is basically a part of the technological range of commodities exports (oil products and crude oil mainly). Therefore, the summary effect of embargo introduction during the first stage would be an abrupt currency income decrease (within 50-55%) for Belarusian residents.

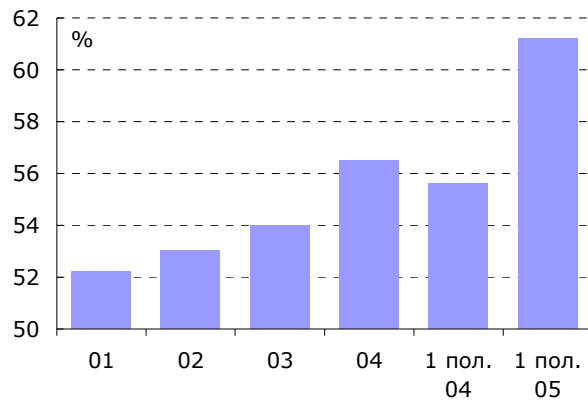
Fig.3. The share of four main export items within the overall export to non-CIS countries



Source: Ministry of Statistics and Analysis

The trends on currency market segments listed below are not dependent on the date of an embargo introduction. The proposed date allows submission of approximate quantitative indices **of tender** outcome on these segments.

Fig.4. The share of four main items exported to non-CIS countries within the cumulative export



Source: Ministry of Statistics and Analysis.

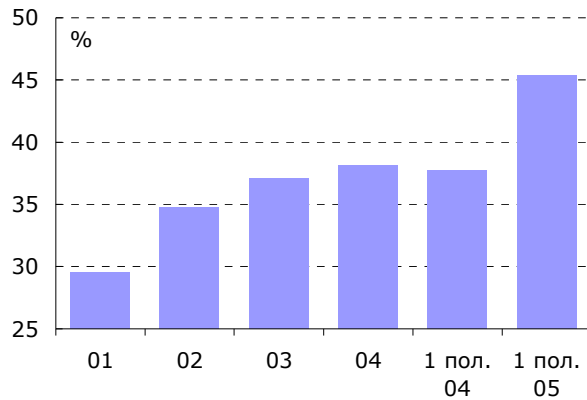
If an embargo is introduced on January, 1, 2006¹ while other conditions remain the same (the absence of any significant price changes for oil, oil products, potassium, textiles and other commodities), export income loss will reach \$ 2.200-2.500 Mio. In the case of an abrupt embargo introduction, Belarusian enterprises would have no time to update their import volumes. As such, the first stage, export income losses, would hardly be compensated by import expenditures decreases.

In such a situation the internal currency market would be forced to enact significant transformations. First, the juridical residents market would face serious changes. Given no chance for Belarusian enterprises to immediately decrease import expenditures as a counter-measure to export reductions, during the first stage they would attempt to reduce currency demand. Moreover, an expected deficit of currency resources may cause an opposite reaction – the enterprises may start to increase currency demand. Considering both trends one can assume that during the first stage the demand within the resident segment would in fact remain the same. Belarusian enterprises usually sell about 52-55% of export income. In the case of an embargo this share would be reduced to its minimum. They would most probably sell about 30% of received income, which is an obligatory rate. A range of directive measures, as well as the need for working capital, would force Belarusian enterprises to somewhat increase this share. Thus we assume Belarus' enterprises would be selling about 30-35% of overall received income. Consequently, simultaneous reduction of export income volume and its share sold by residents on the internal currency market would cause a supply decrease (about 63-68%) if compared with an inertia scenario.

Such supply and demand dynamics within the market segment would set (for the first quarter of 2006) the deficit at approximately \$ 700-750 Mio. The non-resident segment would hardly run any significant transformations during the first stage. It would likely be characterized by a gradual decrease of non-residents' demand and supply activities. Therefore, the share of the non-resident segment within the overall currency market would be reduced. In the first quarter of 2006, such a situation would be equivalent to the deficit of this segment of the market at the rate of \$120-170 Mio. The demand for currency is likely to increase among the domestic market. However, the population would mainly increase currency demands within their current incomes, but would not start converting its ruble savings into currency. Therefore, currency demand increase is likely to follow as an initial reaction of the domestic market, while dimensions of currency

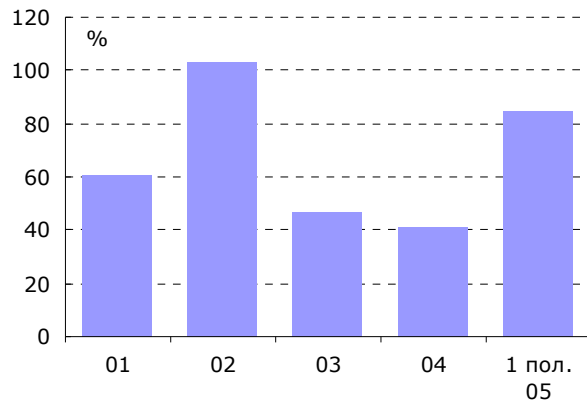
supply would remain the same. In the first quarter of 2006, the situation would be equivalent to the deficit within the market segment at the rate of \$ 180-230 Mio. As a result in the first quarter, after introduction of an embargo Belarus' internal currency market would face a currency deficit at the rate of \$1000 – 1150 Mio.

Fig. 5 The share of EU countries in Belarus' export



Source: Ministry of Statistics and Analysis.

Fig. 6. Growth of export to EU countries within overall export increase



Source: Ministry of Statistics and Analysis.

Budgetary sector

Since during the first stage, the activity of Belarusian exporters would likely be notably limited, a significant reduction of budgetary income from external trade activities and operations can be expected. The current share of such income within the consolidated budgetary income comprises about 5.5%.

Other important income sources are the income tax and the value-added tax (VAT). During the first stage as a result of a decrease in sales volume and, consequently, of profits for the aforementioned branches, the revenue from income taxes would be notably reduced. The decrease of VAT income would primarily not be that significant since Belarus' export is zero-rate taxed, whereas the reduction of import, which is the main source of VAT income to the budget, would be running quite smoothly.

If an embargo was introduced and 90% of the activities of the 17 main enterprises-exporters to the western markets were paralyzed, the budget would lose about 12-13 % of tax income. Hence, this would considerably reduce the budgetary capacity of financing social programs and supporting various enterprises and branches (such as agriculture, municipal economy, construction, etc).

Stage 2: influence over investments and labor market, devaluation of BLR ruble, currency resource decreases, and budget adaptation.

Real sector

Output reduction within the industries immediately affected by an embargo would bring negative consequences to the labor market. Mass redundancies are unlikely to follow so far as their social outcome is utterly destructive for the political regime. At the same time, transition to a less than full-time working week and other forms of concealed unemployment remain possible, as seen previously during critical periods of economic development in Belarus in order to reduce expenditures. Still, there is a possibility of salary decreases and/or wage arrears.

Investment reduction is another consequence of introduction of an embargo. Since a number of enterprises – oil refinery and ferrous metallurgy in particular – are mainly supported by foreign investments, the suspension of support for these industries would notably affect the overall investment dynamics. Moreover, the negative influence of the decreases in the aforementioned branches in relation to the state budget and the economy as a whole would severely damage investment activity in other sectors.

Monetary sector

A growing deficit in the currency market would definitely require The National Bank of Belarus² (NBB) to attempt to stabilize the situation. Other things being equal, the NBB would be forced to sell its currency reserves or devalue the BLR ruble. However, these two conducts cannot be fully considered as alternatives. If in such a situation the NBB intended to avoid devaluation, it would be obliged to sell its gold and currency reserves (NBB summary international reserves are in fact equivalent to the total of the expected deficit within the currency market). Thus, the NBB itself might provoke an inevitable ruble devaluation due to exhausted assets. If it were to refuse both to accept foreign currency investments and to consent to significant devaluation which could somewhat balance the currency market, the NBB would be forced to abruptly devalue the BLR ruble (20-30% **in real value**) Due to the reaction of the population, such a scenario would entail further deficit growth in the currency market and, consequently, the necessity of using currency reserves.

Therefore, during the second stage after the establishment of a significant deficit in the internal currency market, simultaneous NBB currency interventions and BLR ruble devaluation (up to 10-15 % **in real value**) would likely follow. Moreover, the NBB would likely be obliged to sell about \$500-600 Mio of its reserved assets.

² We assume that economic trends within the three stages are inevitable, even with the intervention of the government and the NBB. Economic policy measures may change the situation only after these inevitable consequences of an embargo introduction, which would last approximately 2 quarters, occur in Belarus.

Budgetary sector

The abrupt decrease of budgetary income would entail the necessity of expenditure reductions. The expenditures for less important enterprises and branches would most likely be reduced, so far as certain expenditures appear to be unavoidable (sowing campaign, financing, budgetary sphere, etc). Moreover, public utilities price growth and reductions of construction of housing and objects of socio-cultural importance, etc., may be expected. However, budgetary expenditure reduction would not seem to be so catastrophic, as the government would have the possibility to partially finance these expenditures using accumulated deposits.

The scheduled campaigns for minimum wage increases may be postponed for an uncertain time. Budgetary employees' incomes may appear "stalled." Pension increases would likely be shelved due to the deterioration of the social insurance fund; in fact pensions may not be paid on time.

The reduction of tax-income from enterprises-exporters against the backdrop of increases in budgetary debts through other industries would lead to a budgetary deficit increase and, consequently, the need to search for additional financing sources.

Stage 3: cumulative and monetary demand decreases, inflation growth, and revision of budgetary parameters

Real sector

The reduction (or abrupt decrease in growth) of the population's real income due to delays in salary payments and working time loss would entail a drop in household consumption fall. Alongside the decrease of investments into fixed capital, this would cause GDP loss. Also, due to the negative consequences of the embargo on the budget, a reduction of state consumption may be expected.

On the other hand, income and investment decreases would ensure import demand reductions. However, within a short period of time this would not positively influence cumulative demand, so far as export decreases are to be quite dynamic.

Monetary sector

The BLR ruble devaluation may entail a significant decrease of demand for Belarusian rubles in circulation and savings. Primarily due to decreases in incomes, money circulation would appear to be much more dynamic. A considerable decrease of real monetary demand would entail the formation of an excessive monetary mass within the economy, which would only aggravate inflation. Consequently, real interest rates would be notably reduced, thereby increasing demand for foreign currency amongst citizens and economic agents. This factor is likely to increase currency demand within the population at the rate of \$700-800 Mio. Such conduct would additionally stimulate price growth within the economy due to excessive money and further pressure over currency exchange rates. Hence, the preconditions for a further deficit would be created within the currency market, and the inflation growth would reach 30-40% per year.

Budgetary sector

During the third stage, the income and expenditure sectors of the budget are likely to be reviewed. The deficit thus may increase up to 8-10% of GDP. Taxation growth may also be expected within the economy as a whole, and additional sources of budgetary deficit financing may be used.

Remarks from the Pontis's Institute for Civic Diplomacy:

The declared success of the Belarus economy (GDP growth of 11% in 2004), as well as the results of exports into EU countries presented in this policy paper is based on a difference in “special” import prices of raw materials for energy production from Russia (oil, natural gas) and its real value on the world markets.

The presented statistics on foreign trade are attributable to the significant growth of value of exports into EU countries - namely, the value of oil products that form the bulk of Belarusian export increases. Those products are exported into EU countries at world prices, respectively with the prices for oil-fuel (diesel), gasoline, or for heating oils, created in the stock market in Rotterdam. However, these products are produced from Russian oil, the price of which for Belarus is significantly lower than actual world prices. Thanks to this, the distinctive difference between relative input (crude oil) and output (regular oil products) prices creates the basis for the success of the Belarusian economy and export. Therefore, there is an artificially lower pricing of oil products from Belarus, as prices of inputs for its production do not correspond with world prices, and they are markedly undervalued. However, this applies to other Belarusian export products as well. A substantial part of raw materials for energy inputs necessary for their production is based on undervalued prices of natural gas, which is the main source for production of electricity in Belarus.

For Russian companies, indeed, supply of undervalued raw materials for energy-related production could present a win-win scheme. Assumptions can be made that the exporting of oil products from Belarus to EU markets is to a great extent done through corporations which are financially connected with Russian companies. The scheme can be as follows. Russian oil companies supply oil for undervalued prices to Belarusian refineries. Regular oil products are produced there which are thereafter exported to EU markets through corporations financially connected to the same Russian oil companies. The fact that the substantial part of such exports is implemented through the Netherlands and Great Britain only supports this assumption. It is widely known that Russian companies, including oil companies, have their subsidiary corporations established in these two exact countries. On the one hand they use tax relieves provided by Netherlands and Great Britain to trade with companies on certain conditions, and on the other hand, these corporations are eligible for benefits based on the fact that they are registered and working within the EU market. Further, people with direct contacts to the Belarusian presidential administration and government likely stand behind these companies since exporting is controlled and regulated by the state, which is especially relevant to the export of oil products.

This trade import-export scheme is convenient for the ruling regime in Belarus. Russian companies have to respect the interests of the Belarusian administration in order for Russian oil companies to export regular oil products to EU markets. The Belarusian refinery in Mozyr is basically the single large-capacity refinery in the area of both Russia and Belarus, which is technologically able to produce oil products from Russian oil (especially diesel and heating oils) while meeting the demanding ecologic standards of the EU. Other refineries are either unable or extremely limited in their capacity to

produce such products. Without meeting these standards, oil products from Russian and Belarusian refineries are not able to enter EU markets. Moreover, the Belarusian refinery also has an advantageous geographical location connecting it to EU markets.

Prohibition of oil product exports from Belarus would not have any effect on the EU market. However, such a prohibition would undoubtedly strike the economic interests of Belarus as well as the private economic interests of members of the highest leadership of Belarus (presidential administration and government) and would have a very negative impact for them.